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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

DANIEL H. DEUTSCH and EVELYN M. DEUTSCH, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

JUL 1 1968
FBI

ALFRED DEUTSCH and BERNICE DEUTSCH, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

WILLIAM DRELL and ETHEL DRELL, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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The Tax Court correctly held that the value of stock was includible in taxpayers' income in 1960, when the stock was unconditionally received, rather than in 1959, when the stock had not yet been issued to taxpayers and was held in escrow for the benefit of taxpayers' employer-----

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 22,444

DANIEL H. DEUTSCH and EVELYN M. DEUTSCH, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ALFRED DEUTSCH and BERNICE DEUTSCH, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

WILLIAM DRELL and ETHEL DRELL, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 92-111) are not officially reported.

JURISDICTION

This petition for review (I-R. 130-133) involves federal income taxes for the calendar years 1960 and 1961. On October 6, 1964, the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiency asserting a deficiency against Dr. and Mrs. Daniel Deutsch for the taxable year ended December 31, 1960, in the amount of \$45,016.13 and an overassessment for the taxable year

ended December 31, 1961, in the amount of \$5,336.78 (I-R. 13-17); a deficiency against Dr. and Mrs. Alfred Deutsch for the taxable year ended December 31, 1960, in the amount of \$23,046.13 and an overassessment for the taxable year ended December 31, 1961, in the amount of \$5,551.46 (I-R. 34-38); and a deficiency against Dr. and Mrs. William Drell for the taxable year ended December 31, 1960, in the amount of \$28,695.09 and an overassessment for the taxable year ended December 31, 1961, in the amount of \$5,294 (I-R. 56-60). Within 90 days thereafter, on January 4, 1965, taxpayers petitioned the Tax Court for a redetermination of the deficiencies and the overassessments asserted for the taxable years 1960 and 1961 under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-18, 22-39, 44-61.) On November 8, 1966, a joint motion to consolidate for trial and briefing was granted. (I-R. 87-88.) The decisions of the Tax Court were entered on August 21, 1967. (I-R. 117, 123, 129.) These cases are brought to this Court by a petition for review filed on October 16, 1967 (I-R. 130-133), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court correctly held that the value of stock was includible in taxpayers' income in 1960, when the stock was unconditionally received, rather than in 1959, when the stock had not yet been issued to taxpayers and was held in escrow for the benefit of taxpayers' employer.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

(26 U.S.C. 1964 ed., Sec. 61.)

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) General Rule.--The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * *

(26 U.S.C. 1964 ed., Sec. 451.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.451-2 Constructive receipt of income.

(a) General rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. * * *

* * * *

(26 C.F.R., Sec. 1.451-2.)

STATEMENT

The facts, as stipulated by the parties (I-R. 76-86) and as found by the Tax Court (I-R. 93-104), may be summarized as follows:

Daniel H. and Evelyn M. Deutsch, husband and wife, Alfred and Bernice Deutsch, husband and wife, and William and Ethel Drell, husband and wife, resided in Pasadena, California, at the time of the filing of their petitions in this case and filed their joint returns for the calendar year 1960 with the District Director of Internal Revenue at Los Angeles, California. The cash basis of accounting was used in computing the income reported by the parties on their federal income tax returns. (I-R. 93-94; II-R. 16, Exs. 1-A, 2-B, 3-C.)

In 1952, Alfred Deutsch, Daniel H. Deutsch, and William Drell (hereinafter referred to collectively as "taxpayers" or individually by their given names), chemists by profession, formed a nonprofit California corporation called the Foundation for Biochemical Research (hereinafter referred to as "the Foundation"). Taxpayers were officers of the Foundation and members of its eight-member board of trustees. The Foundation engaged in both research and commercial activities. (I-R. 94.)

In 1958, the Foundation's board of trustees decided to form a separate corporation to assume the Foundation's commercial activities. Accordingly, in March, 1958, the California Corporation for Biochemical Research (hereinafter referred to as "the Corporation")

was incorporated under the laws of California by the taxpayers to take over the commercial activities of the Foundation, thereby engaging in the manufacture and sale of biochemicals. In the same month, the Corporation assumed operation of the Foundation's commercial activities on behalf of the Foundation. Taxpayers were officers and directors of the newly-formed Corporation, and one Bernard Malin was the Corporation's treasurer from its inception to 1960 and a director for a portion of this period. The Corporation was authorized to issue common stock (par value \$1) and preferred stock (par value \$100). The preferred stock was convertible to common stock at the ratio of one share of preferred stock for 100 shares of common stock. (I-R. 94-95; II-R. 22.)

In September, 1958, an agreement was entered into between the Foundation and the Corporation whereby all of the operating assets of the Foundation were to be transferred to the Corporation in exchange for 1,920 shares of preferred stock of the Corporation and 116 shares of common stock of the Corporation. Thereafter, the Corporation filed an application with the Commissioner of Corporations of the State of California (hereinafter referred to as the "Corporation Commissioner") requesting, among other things, (1) permission to sell and issue to the Foundation 1,920 shares of preferred stock and 116 shares of common stock, (2) permission to sell 150,000 shares of common stock to the public, and (3) permission to issue 150,116 shares of common stock to Daniel, William, and Alfred, the promoters of the Corporation. ^{1/} This application contemplated that

^{1/} Apparently it was necessary that the preferred stock issued to the Foundation be converted to common stock before the common stock could be issued to the promoters.

the Foundation's shares would be issued and placed in escrow prior to the sale of any shares to the public and prior to the issuance of any promotional shares. (I-R. 80-81, 95-96.)

As a condition for authorizing the issuance of stock by the Corporation (and for authorizing sale to the public of 150,000 shares of common stock), the Corporation Commissioner imposed certain restrictions upon the shares to be issued to the Foundation and to the promoters, which restrictions were set forth in a permit dated October 23, 1958, authorizing the issuance and public sale of the stock. (I-R. 81, 96; II-R. 16, Ex. 8-H.)

The permit provided for the issuance by the Corporation to the Foundation of 1,920 of its preferred shares and 116 of its common shares in payment for the assets of the Foundation transferred to the Corporation and for the conversion of the preferred shares to common shares on a basis of 100 shares of common for one share of preferred with the following restrictions and conditions (I-R. 96-97; Ex. 8-H):

(b) That none of the shares authorized * * * [to be issued to the Foundation and the promoters] shall be sold or issued unless and until applicant shall have selected an escrow holder and said escrow holder shall have been first approved in writing by the Commissioner of Corporations; that, when issued, all certificates evidencing any of said shares shall be forthwith deposited with said escrow holder, to be held as an escrow pending the further written order of the said Commissioner; that the receipt of said escrow holder for said certificates shall be filed with said Commissioner; and that any owner or person entitled to said shares shall not consummate a sale or transfer of said shares, or any interest therein, or receive any consideration therefor, until the written consent of said Commissioner shall have been obtained so to do.

The permit placed additional restrictions upon the sale of the stock which was to be issued to the promoters. (I-R. 97.)

The Corporation designated the Union Bank of Los Angeles as escrow holder for the shares to be issued to the Foundation and to the promoters pursuant to the permit, and on October 23, 1958, the Corporation Commissioner approved such designation.

(I-R. 82, 97; II-R. 16, Ex. 9-I.) The escrow agreement provided for release of the stock placed in escrow upon application for such release to and authorization for such release by the Corporation Commissioner and, if a public offering of the stock were made, in no event in less than one year from the commencement of the public offering. (I-R. 97.)

On October 24, 1958, having made the foregoing arrangements, the Foundation and the Corporation executed an "Agreement, Bill of Sale and Assignment" by which the Foundation transferred assets valued at \$192,116.72 to the Corporation. In consideration for the assets transferred by the Foundation, the Corporation issued 1,920 shares of convertible preferred stock and 116 shares of common stock, the certificates of which were placed in escrow. (I-R. 79-80, 95-96; II-R. 16, Ex. 7-G.) Accordingly, on October 28, 1958, the Corporation placed in escrow 1,920 shares of preferred and 116 shares of common stock to be held for the Foundation in accordance with the escrow agreement and subject to the restrictions set forth in the permit. (I-R. 82-83, 97-98.)

Between October 27, 1958, and April 24, 1959, 150,000 shares of the common stock of the Corporation were sold to the public at \$1 per share. These 150,000 shares constituted all of the stock authorized by the Corporation Commissioner to be sold to the public. (I-R. 83, 98.)

In October, 1958, the Foundation owed taxpayers the following amounts representing salaries for services previously performed as officers of the Foundation dating as far back as 1953 (I-R. 98, 101):

Alfred Deutsch	\$5,443
Daniel Deutsch	9,267
William Drell	<u>6,452</u>
Total	\$21,162

Subsequent to October, 1958, and until sometime in 1960 the Foundation continued to accrue additional salaries payable to the taxpayers. (I-R. 98.)

In October and November, 1958, taxpayers discussed with the other trustees of the Foundation taking some of the stock of the Corporation issued or to be issued to the Foundation as satisfaction for the back salaries due them at the rate of \$1 per share of common stock. At the time of these discussions taxpayers and the other trustees were all aware that it would be at least a year and perhaps longer before the preferred stock could be released from the escrow agreement and converted to common stock. They and the other trustees were aware of the restrictions placed on

the issuance and sale of the stock by the Corporation Commissioner in granting the permit to issue the stock. Sometime late in 1958 or early in 1959 taxpayers and the other trustees of the Foundation reached an agreement with respect to transfers of stock of the Corporation to taxpayers for back salaries. (I-R. 98-99.)^{2/}

This agreement among Alfred, Daniel, and William, and the other trustees of the Foundation with respect to the back salaries due taxpayers by the Foundation was reduced to writing on January 3, 1959, and signed by Alfred, Daniel, and William only. The instrument was entitled "Memo of Agreement" and read as follows (I-R. 84-85, 100; II-R. 16, Ex. 13-M):

^{2/} Bernard Malin (hereinafter referred to as "Malin") is an attorney and a certified public accountant. He had done some work for the Foundation, and in October, 1958, the Foundation owed him approximately \$10,000. Malin suggested to Alfred that he be paid in stock. Alfred discouraged bringing this proposition before the board of trustees of the Foundation. Later Alfred, Daniel, and William discussed with Malin the sale to him of a portion of the stock they were considering taking in payment of back salaries owed to them by the Foundation. At the time of these discussions Malin could have purchased stock from the public offering at \$1 a share but did not have funds immediately available for the purchase of such shares partially because of not having received payment from the Foundation for the amount of fees owing to him. Malin was at the time doing work for the Corporation, and Alfred, Daniel, and William were desirous of having Malin continue working for the Corporation and of having him have a financial interest in the Corporation. In January, 1959, taxpayers entered into an agreement with Malin to sell him at \$1 per share one-fourth of the 21,162 shares of stock which was the aggregate amount to be transferred to them by the Foundation for back salaries. To provide the 5,290 shares to be sold to Malin, taxpayers agreed among themselves that Daniel and William would each sell Malin the shares due them by the Corporation in excess of 5,291 and Alfred would sell to Malin the shares due him in excess of 5,290 shares. (I-R. 99-100.)

The undersigned officers hereby agree that they will not request cash payment in satisfaction of the back salaries now owing to them and standing on the books of the Foundation, but will accept in lieu of cash an equal amount of common stock of Calif. Corp. for Biochemical Research as follows:

Alfred Deutsch	5,443 shs.
Daniel H. Deutsch	9,267 shs.
William Drell	6,452 shs.

They further agree that these shares of stock be transferred to them in due course after the Foundation preferred stock has been released from escrow and converted to common shares, provided that such shares are transferred within 5 years of this date.

On January 11, 1960, the Corporation filed an application with the Corporation Commissioner to withdraw from escrow the 1,920 shares of preferred stock and 116 shares of common stock held for the Foundation. The Corporation Commissioner on January 22, 1960,^{3/} issued an order partially terminating the escrow, which order constituted his consent to the withdrawal of 1,920 preferred and 116 common shares. These shares were delivered to the Foundation, and on February 15, 1960, the Foundation caused 242 shares of preferred stock to be converted into 24,200 shares of common stock. This was accomplished by having the Corporation cancel the 242 preferred shares and issue the 24,200 common shares to the Foundation. (I-R. 83-84, 101; II-R. 16, Exs. 10-J, 11-K.) The minutes of the meeting of the board of trustees of the Foundation

^{3/} The Tax Court findings (I-R. 101) erroneously set forth the date of the order as January 20, 1960. (See I-R. 107; II-R. 16, Ex. 11-K.)

held March 24, 1960, contained the following statement and resolution with respect to these shares (I-R. 101):

TRANSFER OF STOCK:

The Board ~~of~~ [sic] discussed the agreement made on January 3, 1959 whereby 21,162 shares of Common Stock, then valued at approximately \$1.00 per share, were to be exchanged for a like amount of back salaries accumulated on the books of the Foundation since 1953. The Board was in agreement that this arrangement was properly entered into and after due consideration the following resolution was unanimously adopted:

RESOLVED, THAT the Officers be instructed to confer with Counsel with the view towards implementing as expeditiously [sic] as possible the memo of agreement, dated January 3, 1959.

On April 7, 1960, the Foundation endorsed certificates representing 21,162 shares of common stock of the Corporation and delivered those certificates to the taxpayers. ^{4/} (I-R. 84, 101.)

4/ The taxpayers had decided that to facilitate the sale to Malin of the stock which they had previously agreed to sell him, the new certificate for the 5,290 shares to be sold to him would be issued by the Corporation in Alfred's name. Accordingly, the books and records of the Corporation indicate that on May 5 and 6, 1960, new certificates were issued by the Corporation to the taxpayers as follows:

Alfred Deutsch	10,580
Daniel Deutsch	5,291
William Drell	<u>5,291</u>
	21,162

During 1960, but subsequent to May of that year, Alfred transferred 5,290 of the shares issued by the Corporation to him in May to Malin, who paid him \$5,290 therefor, which amount was divided among taxpayers on the basis of the number of shares each had agreed to sell to Malin. (I-R. 84, 101-102; II-R. 16, Ex. 12-L.)

At all times between October 15, 1959, and May 30, 1960, the fair market value of the common stock of the Corporation was \$8 per share. (I-R. 85, 102.)

Taxpayers did not report any income on their income tax returns for the calendar year 1959 with respect to the 21,162 shares of stock which were the subject of the January 3, 1959, agreement. Each taxpayer on his federal income tax return for the calendar year 1961 reported capital gain from sales of stock of the Corporation which was stated to have been acquired on April 7, 1960. The stock sold by each taxpayer in 1961 was stock received from the Foundation pursuant to the agreement of January 3, 1959. (I-R. 85-86, 102.)

A document submitted to the Corporation Commissioner by the Corporation, entitled "Offering Circular" and dated April 27, 1961, contained the statement that "during 1960 the three directors of the Corporation, who are also three of eight trustees of the Foundation, received accrued officers' salaries due from the Foundation in the form of 21,162 shares of common stock of the Corporation." Moreover, the accrued salaries payable to taxpayers remained as liabilities on the books and records of the Foundation until April 30, 1960, at which time an adjusting entry was made reflecting payment by a distribution of 21,162 shares of stock of the Corporation then held in the Foundation's investment account. Each taxpayer on his federal income tax return for the calendar year 1960, which was

prepared by the accountant Malin, reported an amount as income from salary attributable to the receipt of the stock from the Foundation. The amount reported by each was as follows:

	<u>Stock (at \$1 Per Share)</u>	<u>Tax Withheld</u>	<u>Total</u>
Alfred	\$ 5,443.00	\$1,268.00	\$ 6,711.00
Daniel	9,267.00	1,600.00	10,867.00
William	<u>6,452.00</u>	<u>1,450.00</u>	<u>7,902.00</u>
	\$21,162.00	\$4,318.00	\$25,480.00

The amount of withholding represented salaries credited by the Foundation to each taxpayer after October, 1958. (I-R. 85, 103.)

The Commissioner, in his statutory notices of deficiency, claimed that taxpayers should have been taxed on the fair market value of the stock as it existed in 1960, which was subsequently stipulated as being \$8 per share. (I-R. 13-17, 34-38, 56-60, 85, 102 ; II-R. 12.)

The Tax Court has held that the Commissioner's position is correct, and that taxpayers received the stock in 1960, at which time it is includible in their income for that year at \$8 per share. The court reasoned that the 1959 contract, which entitled taxpayers to receive stock in the future, did not convey a present interest to them. With respect to the 5,290 shares which taxpayers sold to Malin, however, the court held that it was

includible in taxpayers' 1960 income at only \$1 a share, "since they were committed to sell it to Malin for that price." (I-R. 104-111.) Taxpayers appealed the Tax Court's decision that 1960 was the year in which they received their stock and should report income in respect thereto. (I-R. 130-135.) The Commissioner decided not to appeal the treatment of the stock sold by taxpayers to Malin.

SUMMARY OF ARGUMENT

Taxpayers are taxable in the year that they received stock as compensation. This case involves the factual question of determining the year during which the stock was received. Taxpayers signed a "Memo of Agreement" in 1959 in which they announced their intention to accept stock in the newly-formed Corporation in satisfaction of accrued salaries due them from their employer, the Foundation. They claim that the signing of this memo constituted receipt of the stock and that it was accordingly received in 1959. However, the Foundation was also to receive stock in the Corporation, and a portion of the Foundation's stock had to be converted from preferred to common before taxpayers could receive any shares. At the time that the memo was executed, the Foundation's shares were held in escrow and could not be released without the consent of the Corporation Commissioner. The Corporation Commissioner's consent was neither sought nor given until 1960. It was only after the shares were released from escrow in 1960 that the Foundation was able to exercise its right to convert the preferred

shares to common and transfer the specified amount of shares to taxpayers. Prior to taxpayers' receipt of the stock in 1960, their right to draw upon the stock was completely restricted. Taxpayers had no control over these restrictions, and the right to sell the shares was not theirs until the stock was received in 1960. We submit that the facts in this case completely substantiate the Tax Court's decision that taxpayers received the stock in 1960 and were accordingly taxable in the amount of its fair market value at that time.

ARGUMENT

THE TAX COURT CORRECTLY HELD THAT THE VALUE OF THE STOCK WAS INCLUDIBLE IN TAXPAYERS' INCOME IN 1960, WHEN THE STOCK WAS UNCONDITIONALLY RECEIVED, RATHER THAN IN 1959, WHEN THE STOCK HAD NOT YET BEEN ISSUED TO TAXPAYERS AND WAS HELD IN ESCROW FOR THE BENEFIT OF TAXPAYERS' EMPLOYER

The issue here is whether taxpayers, who were paid salaries in the form of stock, received the stock in 1959, when it had a fair market value of \$1, or in 1960, when the stock had a fair market value of \$8. The Tax Court held that the facts established that the stock was received in 1960, and, accordingly, was taxable as income in that year. Taxpayers argue a contrary interpretation of the facts which they claim establishes that the stock was received in 1959.

Section 451(a), ^{5/}supra, provides the general rule to be applied for determining the taxable year during which income is to be taxed. The statute provides, in relevant part, "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer * * *." Working in mitigation of the requirement of actual receipt for tax liability on the cash basis is the doctrine of constructive receipt. The Regulations describe the concept of constructive receipt as follows (Treasury Regulations on Income Tax (1954 Code), Section 1.451-2(a), supra):

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. * * *

Accordingly, the application of the constructive receipt doctrine is limited to situations where money or property is available to taxpayers without restriction and failure to receive it results from an exercise of taxpayers' own choice under circumstances

^{5/} All references are to the Internal Revenue Code of 1954 unless otherwise noted.

controlled by them. See Newmark v. Commissioner, 311 F. 2d 913 (C.A. 2d 1962); Hedrick v. Commissioner, 154 F. 2d 90 (C.A. 2d 1946), certiorari denied, 329 U.S. 719.

Taxpayers admit that their receipt of stock in satisfaction of services rendered constitutes gross income. See Section 61(a)(1), supra; 2 Mertens, Law of Federal Income Taxation (Rev.), Section 11.01.^{6/} Taxpayers contend only that they received the stock in 1959. This contention is based upon an instrument they signed in 1959 in which taxpayers stated that they would accept shares in the newly-formed Corporation as satisfaction for accrued salaries owed taxpayers by their employer, the Foundation. At the time the instrument was signed, the Foundation did not have a right to the Corporation's shares and was unsure as to when and if it would acquire the shares. It is the Commissioner's position that, as held by the Tax Court, taxpayers did not receive the shares until 1960 when they actually became available to the Foundation and the Foundation was able to pay the shares to taxpayers. Prior to

^{6/} Taxpayers use the cash method of accounting and therefore would not recognize the stock as income prior to "receipt" as might one using another accepted method. See Code Section 446(c). Moreover, taxpayers do not contest the established principle that income received in the form of stock is measured by the fair market value of the stock at the time of receipt. See 2 Mertens, Law of Federal Income Taxation (Rev.), Sections 11.03, 11.08.

1960, taxpayers' right to the stock was not sufficient to subject them to an income tax.

Taxpayers were employed by the Foundation for a period of years, with unpaid salaries accruing in their favor since 1953. On January 3, 1959, shortly after the Corporation was formed to take over the commercial activities of the Foundation, taxpayers signed an instrument entitled "Memo of Agreement". (I-R. 84-85, 98-100, 101; II-R. 16, Ex. 13-M.) In this instrument which was signed by taxpayers only, taxpayers stated they would not request cash payment in satisfaction of past salaries but "will accept", in lieu of cash, common stock of the Corporation. The terms of the instrument did not evidence the transfer of a present interest to taxpayers. Nor may the instrument be interpreted as placing taxpayers in constructive receipt of the stock. The shares were not set apart for taxpayers so as to enable them to draw upon the shares at any time. On the contrary, taxpayers' receipt of the stock was subject to substantial limitations. They were to receive the shares only after the Foundation received corporate stock which was in escrow at the time the "Memo of Agreement" was signed. Thus, the "Memo of Agreement" further provided that taxpayers would receive the stock only "after the Foundation preferred stock has been released from escrow and converted to common shares, provided that such shares are transferred within 5 years of this date."

The Foundation itself had no right to the stock during 1959. The Corporation Commissioner's permit authorizing the newly-formed Corporation to issue stock in return for the Foundation's assets specified that the shares in question could not be issued unless they were deposited with an escrow holder approved by the Corporation Commissioner, that the shares were to be held in escrow until permitted to be released by the written order of the Corporation Commissioner, and that any owner or person entitled to the shares could not consummate a sale or transfer of the shares, or any interest therein, or receive any consideration therefor, until the written consent of the Corporation Commissioner should have been obtained.^{7/} (I-R. 97; II-R. 16, Ex. 8-H.) These limitations were not satisfied until 1960. Accordingly, it was impossible for taxpayers to obtain any rights to the stock in 1959 simply by signing an instrument by which they stated they would accept stock when and if the Foundation was able to transfer it to them.

It was not until January 11, 1960, that the Corporation Commissioner was requested to grant permission to release from escrow the stock to be transferred to the Foundation. The permission was not granted until January 22, 1960, when the Corporation Commissioner issued an order permitting the withdrawal from

^{7/} This restriction was imposed in accordance with the Commissioner's authority under California law. See Corporations Code, 25 West's Annotated California Codes, Sec. 25,508.

escrow of 1,920 preferred shares and 116 common shares and the transfer of these shares to the Corporation. The Foundation had no right to the stock in question until the Corporation Commissioner issued his order. On February 15, 1960, after receiving the shares released from escrow, the Foundation caused 242 shares of preferred stock to be converted by the Corporation into 24,200 shares of common stock. Subsequent to this conversion, the Foundation's board of trustees, meeting on March 24, 1960, formally approved the arrangement whereby 21,162 shares of common stock of the Corporation were to be transferred to taxpayers in satisfaction of "back salaries accumulated on the books of the Foundation since 1953." (I-R. 101.) Thus, prior to 1960, the substantial restrictions upon taxpayers' rights to the shares precluded taxpayers from constructively or actually receiving the shares (as distinguished from the certificates) or the certificates.

The January 3, 1959, "Memo of Agreement" gave taxpayers no greater rights to the stock than those which had been recognized by the previous accounting for the accrued salaries due taxpayers. Accordingly, the accrued salaries payable to taxpayers remained as liabilities on the books and records of the Foundation until April 30, 1960, when an adjusting entry was made to reflect payment by a distribution of 21,162 shares of stock of the Corporation

then held in the Foundation's investment account. And the taxpayers themselves did not report receipt of the stock on their 1959 income tax returns. Moreover, an "Offering Circular" dated April 27, 1961, submitted to the Corporation Commissioner by the Corporation, contained the statement, confirming the Commissioner's position, that "during 1960 the three directors of the Corporation, who are also three of eight trustees of the Foundation, received accrued officers' salaries due from the Foundation in the form of 21,162 shares of common stock of the Corporation." (I-R. 102-103.)

Cohu v. Commissioner, 8 T.C. 796 (1947)^{8/}, involved a determination of the effect of contractual restrictions upon the question of the year during which promotional shares were received by and taxable to certain taxpayers. In that case, as in the instant case, the Corporation Commissioner's permit required his approval before the issuance of the stock to taxpayers, and this approval was not given until 1940, one year after taxpayers alleged their constructive receipt. The court concluded that taxpayers' contractual right to receive stock in the future was not constructive receipt of the stock and refused to consider the contracts themselves as constituting taxable income, since they were not what taxpayers had bargained for but were merely evidence of taxpayers' right to the stock for which they had bargained. Accordingly, taxpayers'

^{8/} John K. Northrop and Inez H. Nothrop, parties in that case, appealed with respect to the valuation issue as decided by the Tax Court. The appeal was ultimately settled. (See 49-2 U.S.T.C., par. 9406.) The issue of valuation is not involved in this case.

suggestion (Br. 9, 10) of analogizing the instant contract to an option to purchase stock which was specifically bargained for by a taxpayer is unjustified. Moreover, contrary to taxpayers' assertion (Br. 8), the mere labeling of the stock to be received as promotional shares does not distinguish the Cohu decision from the instant case. As in Cohu, in the instant case taxpayers were receiving stock in consideration for their services as promoters of the Corporation as well as for other services.

In Hall v. Commissioner, 15 T.C. 195 (1950), affirmed per curiam, 194 F. 2d 538 (1952), this Court accepted the position adopted by the Commissioner in the instant case. The taxpayer there contended that he became the owner of 50 shares of stock in 1942 when he signed a contract entitling him to the shares. However, this Court agreed with the Tax Court's decision that the shares did not constitute taxable income until 1943 and 1944, at which times the taxpayer acquired the unfettered right of sale, which is one of the most important attributes of ownership. Similarly, taxpayers in the instant case did not acquire the unfettered right of sale until 1960 when the Foundation was able to deliver the stock to them.

Taxpayers cite (Br. 8) Robbins v. Pacific Eastern Corp., 65 P. 2d 42 (Calif. S. Ct. 1937), as authority for the proposition that in certain circumstances the State of California does not

require the physical delivery of a certificate to pass title to stock. See also California cases cited by taxpayers.(Br. 9.) However, this does not aid taxpayers in meeting their burden of proving that title or any other interest in the stock was passed to taxpayers in 1959. As previously noted, the instrument signed by taxpayers in 1959 evidenced their mere expectation of receiving the stock.^{9/}

Accordingly, we submit that taxpayers received the stock in 1960 and that the stock is includible in their income in that year at its fair market value.^{10/}

^{9/} We further submit that Estate of Hobson v. Commissioner, 17 T.C. 854 (1951), is not authority for taxpayers' assertion (Br. 8) that any dividends which would have been declared in 1959 would have been held for the credit of taxpayers. Such an assertion is without any foundation in the record.

^{10/} The fair market value of the 5,291 shares received both by Daniel and by William and the 5,290 shares received by Alfred for his own retention was \$8 per share as stipulated by the parties. (I-R. 85, 102.) Taxpayers are also taxable in 1960 for the additional 5,290 shares which were received by them in 1960 but which were immediately transferred to Malin for \$1 per share. However, the value attributed to the latter shares is limited to \$1 because of taxpayers' obligation to sell to Malin at \$1. Thus, contrary to taxpayers' claim (Br. 10, 11), the Tax Court did not permit taxpayers to be subject to tax in 1959 upon the shares transferred to Malin. Rather, taxpayers were taxable upon all the shares in 1960, but the fair market value of the shares which they were obligated to transfer to Malin for \$1 was established at that price rather than the fair market value of \$8.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: This _____ day of _____, 1968.

Attorney.